

THE REGULATION OF CORPORATE ACQUISITIONS: A LAW AND ECONOMICS ANALYSIS OF EUROPEAN PROPOSALS FOR REFORM

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I. INTRODUCTION

The central purpose of the unification of Europe is to create a regulatory environment in which the principle of free trade in goods, services, people, and capital is enforced.¹ This is made clear in the Treaty of Rome, which established the European Economic Community in 1957.² Regulation of the market for corporate control has attempted not only to harmonize the laws of the member states, but also, at least ostensibly, to facilitate hostile takeovers in Europe.³ Thus, for example, the Proposal for the Thirteenth Council Directive on Company Law, Concerning Take-overs and Other General Bids (the "Proposed Thirteenth Directive") attempts to facilitate hostile takeovers.⁴ The reason given for the proposal is "the desire to alter the European corporate governance environment to encourage a corporate acquisition response to perceived changes in the economic environment that are believed to have changed the efficient boundary of the firm."⁵

A major pro-takeover element of the proposed directive significantly curtails the ability of target management to respond defensively after an outside bid has been made. While, for example, Delaware state law permits the issuance of special types

¹ Treaty Establishing The European Economic Community, March 25, 1957, arts. 2 and 3, 298 U.N.T.S. 11 [hereinafter Treaty of Rome].

² Originally, there were three communities: the European Economic Community ("EEC"), the European Coal and Steel Community ("ECSC") and the European Atomic Energy Community ("Euratom"). But in practice, they have often operated as one organization, and after the Treaty on European Union and Final Act, Feb. 7, 1992, 31 I.L.M. 247 [hereinafter Maastricht Treaty], they eventually became the European Union ("EU").

³ See Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Governance Environment*, 61 *FORDHAM L. REV.* 161, 176 (1992).

⁴ Council Directive No. 90/416, art. 9, 1990 O.J. (C 240) 9 [hereinafter Proposed Thirteenth Directive].

⁵ See Gilson, *supra* note 3, at 176. The EU has a somewhat ambivalent attitude towards mergers, acquisitions and monopolies. Besides the "corporate governance" perspective explored in this article, there are also other considerations. For example, the present policy also considers whether takeovers reduce competition in the EU. A further consideration is whether European corporations or industrial groups are large enough to be able to compete on a global scale, an objective that is sometimes only achievable with some reduction of competition within the EU. The regulatory approach towards takeovers must be seen from various perspectives.

of stock by incumbent management in the midst of a takeover bid in connection with a poison pill takeover defense, such action is prohibited under Article 8(1)(a) of the Proposed Thirteenth Directive.⁶ The proposed directive largely eliminates the possibility of European companies utilizing a poison pill in the face of target shareholder-friendly bids because it requires shareholder approval to issue any securities while a takeover bid is pending. However, the proposed directive does not prohibit adoption of a poison pill, by shareholder vote, prior to the receipt of a takeover bid.⁷ Other defensive tactics (such as issuing dual classes common stock or placing a ceiling on the number of shares that can be voted by a single shareholder), which are generally adopted prior to a bid being announced, are similarly regulated. However, the corporate laws of many EC member states, as well as other EC directives, do limit pre-bid takeover defensive measures.⁸

The Proposed Thirteenth Directive is undergirded by the proposition that a well-functioning market for corporate control is considered an important method for monitoring incumbent management and for improving the allocation of resources within Europe. Takeover bids are common in the United States and the United Kingdom ("U.K."), which has a relatively long history of pro-takeover corporate laws.⁹ Takeover bids are not so

⁶ Proposed Thirteenth Directive, art. 8(1)(a) refers to the fourth indent of art. 2, which prohibits issuance of voting stock "without obtaining the authorization of the general meeting of shareholders within the period of acceptance." This is consistent with most existing company law in the member states and not an innovation brought forth by the Proposed Thirteenth Directive.

⁷ "Takeover bid" is defined in articles 2 and 4 of the Proposed Thirteenth Directive. See generally Proposed Thirteenth Directive, *supra* note 4. Essentially, any person who acquires one-third of the voting rights in a company is obliged to make a bid to acquire all the securities of the target company.

⁸ Council Directive No. 90/629, 1991 O.J. (C 7) 5, Second Amendment to the Proposal of 20 December 1990 for a Fifth Council Directive [hereinafter Proposed Fifth Directive] based on Article 54 of the EEC Treaty Concerning the Structure of Public Limited Companies and the Powers and Obligations of Their Organs. According to the Proposed Fifth Directive, a company would not be allowed to issue shares with differential voting rights. However, shares with limited or no voting rights would be limited to 50 percent of the capital, and special pecuniary advantages must be granted to these shareholders.

⁹ This pro-takeover orientation is reflected in European merger and acquisition activity. In 1988, of 3029 successful acquisitions in Europe, 2287 took place in the U.K. alone. 1 BARRIERS TO TAKEOVERS IN THE EUROPEAN COMMUNITY 1

commonplace on the European continent.¹⁰ In fact, because of more dispersed ownership and legislative restrictions on takeover defenses, the U.K. has been the pioneer in European takeover law.¹¹ Because of these varied positions on takeovers, it is no surprise that the largely U.K.-inspired Proposed Thirteenth Directive has met opposition.¹²

This article examines the regulation of corporate acquisitions in Europe from a law and economics perspective. It concludes that the reform proposals do not meet the stated goal of encouraging acquisitions. Rather, the proposed rules will inhibit acquisitions, which in turn will likely result in less exposure of incumbent management to market discipline and inefficiencies in the allocation of productive resources in Europe.

Section II of the article discusses the theoretical underpinnings of takeover law, with emphasis on Europe. Section III describes the principal regulatory and structural obstacles in the market for corporate control in Europe. Section III also argues that the European rules concerning takeovers are far more intrusive than they appear. Section IV examines regulations that should be implemented if Europe is to achieve a healthy and well-functioning market for corporate control.

(1989) (report commissioned by the U.K. Department of Trade and Industry) [hereinafter 1 BARRIERS TO TAKEOVERS].

¹⁰ *Id.*

¹¹ The main reason for this is the distribution of share ownership. In most European countries (excluding the U.K.), ownership is concentrated in controlling blocks owned by a single shareholder. Bidders cannot acquire the company without acquiring the controlling block. Most bids start with private transactions in which the controlling block is transferred to the bidder. The takeover is completed through a "friendly" bid for the remaining shares. The bid for non-controlling shares is typically mandatory. See Eddy Wymeersch, *Takeover Bids in Europe*, in *NORDIC PERSPECTIVES ON EUROPEAN FINANCIAL INTEGRATION* 234 (Pekka Timmonen ed., 1992); M.A. WEINBERG, *WEINBERG AND BLANK ON TAKEOVERS AND MERGERS* 1001-13 (5th ed. 1989).

¹² The U.K. does not want to give up its self-regulatory approach. Germany and the Netherlands disagree with the restrictions on defensive techniques and the mandatory bid requirement. In general, the rules are not readily welcomed in Italy or Spain. See Wymeersch, *supra* note 11, at 237. The U.K. influence in the Proposed Thirteenth Directive is also apparent by the fact that Professor Robert Pennington (Birmingham) prepared the first report on these matters for the Commission. Accordingly, historical and cultural differences should not be underestimated when the proposal is analyzed.

II. A BANK MONITORING SYSTEM VERSUS A MARKET FOR CORPORATE CONTROL

A well-functioning market for corporate control serves the goal of achieving efficient resource allocation by allocating ownership and control of assets to those who value them most and installing the most able managers. These two mechanisms create three major sources of gains from takeovers: more efficient asset combination, more efficient management, and better corporate governance structures.

Changes in competitive pressure can alter the efficient combination of assets. For example, during the 1980s there were numerous "bust-up" takeovers in which the assets of broadly diversified corporate conglomerates were split up and sold, either as stand-alone companies or to companies in similar lines of business. As Randall Morck has explained, "the source of bust-up gains in the 1980s is the reversal of the unrelated diversification of the 1960s and the 1970s and hostile bust-up takeovers simply undo past conglomeration."¹³ During the 1960s and 1970s, conglomerate mergers, in which corporations acquired firms engaged in lines of businesses unrelated to their own, increased dramatically.¹⁴ By 1974, firms that had no single, dominant line of business came to represent 20.7 percent of the firms in the Fortune 500, up from only 7.3 percent in 1959.¹⁵

Conceivably, some of these mergers may have been consummated because certain particularly talented managers were able to take advantage of generic management skills to improve the productivity of a whole range of businesses, or to improve resource allocation within firms.¹⁶ Alternatively, certain conglomerate mergers were undoubtedly the result of incumbent mana-

¹³ Randall Morck et al., *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31, 47 (1990).

¹⁴ See DAVID J. RAVENSCRAFT & F. M. SCHERER, *MERGERS, SELL-OFFS, AND ECONOMIC EFFICIENCY* 20-55 (1987); MALCOLM S. SALTER & WOLF A. WEINHOLD, *MERGER TRENDS AND PROSPECTS FOR THE 1980s* 2-27 (1980).

¹⁵ Richard P. Rumelt, *Diversification Strategy and Profitability*, 3 STRATEGIC MGMT. J. 361 (1982) (Table 1).

¹⁶ OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, AND RELATIONAL CONTRACTING* 273-97 (1985); Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537 (1981).

gers shielding themselves behind a complex, highly diversified corporate structure. Whatever the cause, conglomerates were inviting targets for corporate raiders because unprofitable branches lowered stock market valuations. Thus, the corporate raiders of the 1980s are perhaps best described as "brokers, rather than permanent owners, helping to redeploy assets to more profitable uses."¹⁷

The hostile acquisition of Revlon by Ronald Perelman in 1985 is an example of how the market for corporate control can improve the operational efficiency of conglomerates. As one investment banker described the transaction:

Revlon had acquired a large range of subsidiaries outside its cosmetics base, including several health care companies. Perelman soon brought in USD 2 billion by selling off most of the other businesses, thus enabling him to spend more money on strengthening the core cosmetics business that had been neglected.¹⁸

Besides improving performance by selling corporate assets to more specialized managers, takeovers can improve performance simply by ensuring that corporate assets are managed more efficiently. Essentially, takeovers serve "to replace ineffective managers."¹⁹ This may explain the typical takeover structure where a less profitable firm is acquired by a more profitable firm.²⁰

By changing the distribution of ownership and control of assets, corporate acquisitions generally, and hostile takeovers in particular, function as a mechanism by which the efficient boundary of the firm adjusts to changes in the efficient boundaries of the industry change resulting from, for example, technological changes. Government regulation raises the transaction costs of the equilibration process, thereby petrifying the existing boundaries of firms and protecting them from the need to respond to a changed economic environment.²¹

¹⁷ Roger E. Alcaly, *The Golden Age of Junk*, THE YORK REVIEW OF BOOKS, May 26, 1994, at 34.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ See Gilson, *supra* note 3, at 182.

This article assumes, and thus does not attempt to prove, that a well functioning market for corporate control improves aggregate welfare through efficiency gains. From this assumption, this article makes two claims. First, due to significant changes in global competition, Europe in the 1990s is in need of a well-functioning market for corporate control. Second, contrary to notions popular among American commentators, commercial banks are not an adequate substitute for the lack of a market for corporate control. The second point is paramount because it pinpoints some of the institutional differences in the market for corporate control between the U.S. and Europe.

European capital markets, with the notable exception of the U.K., are underdeveloped, particularly in comparison with U.S. equity markets. Although European companies need no longer raise most of their outside capital in the U.S. or Japan or denominate their debt and equity issues in non-European currencies,²² Europe still lags behind in the development of equity trading. Stock market capitalization is less than twenty percent of the gross domestic product ("GDP") in France, Germany and Italy. In the U.K., it is 98.1 percent of GDP and is over 100 percent in the U.S.²³ Moreover, the Berle-Means paradigm, which characterizes the publicly held corporation as having "concentrated management, and dispersed, diversified stockholders, shifting control from shareholders to managers," seems inapplicable to European corporations.²⁴ Extremely high concentrations of share ownership in Europe are quite common. In countries such as Italy, France, Germany and Sweden, such concentrations of ownership, particularly among related entities and insiders, make most European companies largely immune to hostile takeovers, at least in the short run. In other countries, such as the Netherlands and Belgium, protective mechanisms are deeply embedded in the corporate laws of the respec-

²² Ingo Walter and Roy C. Smith, *European Investment Banking: Structure, Transactions Flow and Regulation*, in *EUROPEAN BANKING IN THE 1990S* 115 (Jean Dermine ed., 1993).

²³ 1 BARRIERS TO TAKEOVERS, *supra* note 9, at 10; *Market Watch*, BARRON'S, Sept. 18, 1995, at 47.

²⁴ Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

tive country.²⁵

Some commentators, most notably Mark Roe, Julian Franks and Colin Mayer, note that a bank dominated system, such as that which exists in Germany, and, to a somewhat lesser extent, in Japan, can serve as a substitute for the market for corporate control.²⁶ According to this view, large banks exercise the monitoring and management function played by the market for corporate control. Indeed, Roe strongly suggests that unfettered market forces would naturally produce a system of monitoring by strong banks, but that regulation prohibiting the emergence of large block shareholders in American firms has forced the evolution of a market for corporate control.²⁷ In fact, Roe has gone so far as to say that corporate history can be seen as an effort to find substitutes for the direct monitoring that politics disallowed.²⁸ Similarly, Franks and Mayer reject the notion that takeovers are a superior substitute for centralized monitoring by banks, arguing that there can be no presumption that the corporate control market is superior to a bank-dominated capital market.

We find unappealing the argument that centralized monitoring by banks is a suitable, let alone, superior substitute for the market for corporate control as a mechanism to achieve allocational efficiency within public firms for three reasons. First, while the strong bank model fits the reality of Germany, it does not fit the realities of other European countries such as Italy, Belgium, Spain or France, which have neither strong bank systems nor well-functioning markets for corporate control. This is to say that the strong bank model is the result of unique historical economic conditions, and not from a modern economic

²⁵ According to Wymeersch, *supra* note 11, at 235, the Belgian Companies Act of 18 July 1991 enabled the leading families and interest groups to firmly secure control in many of the listed companies. Takeover barriers exist to significantly different degrees in EC countries. See 7 BARRIERS TO TAKEOVERS IN THE EUROPEAN COMMUNITY 22-24 (1989) [hereinafter 7 BARRIERS TO TAKEOVERS].

²⁶ Mark J. Roe, *Political and Legal Restraints on Ownership and Control of Public Companies*, 27 J. FIN. ECON. 7, 35 (1990); Julian Franks & Colin Mayer, *Capital Markets and Corporate Control: A Study of France, Germany and the UK*, 10 ECON. POL'Y 189 (Apr. 1990).

²⁷ Roe, *supra* note 26.

²⁸ *Id.* at 35.

imperative.²⁹

Second, these banks typically exercise what is basically a veto function over proposed projects. Although their monitoring increases during times of financial crisis, they do not effect the massive restructurings that were common during the 1980s in the U.S. In other words, the monitoring and control exercised by banks is fundamentally different than the monitoring exercised by acquirors. Banks make only incremental changes except in times of acute financial crisis.³⁰ Accordingly, banks are better at maintaining and developing already established firms through day-to-day supervision than they are at nurturing emerging firms in new areas of business or at radically restructuring companies due to changes in competitive pressure. Hence, we claim that banks and potential outside acquirors are complementary corporate monitors and controllers rather than substitutes.

Third, and most importantly, it is important to recognize that banks have a dual economic interest in the firms they monitor: that of equity holders and of fixed claimants. Unlike outside acquiror who are solely equity claimants, banks are often primarily interested in making sure that their outstanding loans are repaid. This is true despite the fact that European banks may have an equity claim in the firms to which they loan money because these equity claims are smaller

²⁹ For instance, the U.K. does not have a banking system intimately involved in corporate governance, while Germany does. This may be a result of disparate industrial development in the late eighteenth and early nineteenth centuries, which led to significantly different capital and managerial requirements. See HANS-HERMANN FRANCKE & MICHAEL HUDSON, *BANKING AND FINANCE IN WEST GERMANY* 4 (1984); ALEXANDER GERSCHENKRON, *ECONOMIC BACKWARDNESS IN HISTORICAL PERSPECTIVE* (1962).

³⁰ The paradigm of the strong bank system in Europe is Germany. However, contemporary analysis reveals that even large German banks are both unwilling and incapable of orchestrating significant reorganization of a firm in financial distress. See JEREMY EDWARDS AND KLAUS FISCHER, *BANKS, FINANCE, AND INVESTMENT IN GERMANY* 160-77 (1994). There are many reasons for this, but two significant factors are the extremely high level of loan collateralization (which means banks suffer minimal financial losses in the event of firm collapse) and the general inefficiency of monitoring efforts to detect an impending financial crisis. See *id.* In addition, legal obstacles in Germany, such as co-determination (employee voting rights on supervisory boards), work to prevent radical financial measures in times of financial crisis and even in times of success.

than the fixed claims of the banks. For example, in Germany, the country with the most commercial bank dominated structure, banks do not *own* controlling blocks of equity in German corporations.³¹

As fixed claimants, banks do not have the same incentives to maximize firm value as do equity claimants because they face different returns from risky but potentially very profitable transactions. Thus, banks are inferior monitors in comparison to acquirors who become equity claimants because they have reduced incentives to accept high risk, but positive present value.³² In particular, because of different incentives, monitoring of a large shareholder in control of the firm differs significantly from that of a bank with even large fixed claims on the firm. The differences are exacerbated by the pivotal block holder's power to transfer control to an outside acquiror.

For these three reasons, we do not believe that a system of corporate monitoring by commercial banks, even if such a system existed throughout Europe, is a substitute for a well-functioning market for corporate control. By the same token, the regulatory and structural barriers to takeovers that exist in Europe are the subject of particular concern.

³¹ Josef Esser, *Bank Power in West Germany Revised*, 13 W. EUR. POL'Y 17 (1990) (noting that by 1986, German banks as a group owned more than 10 percent of the equity in only 86 German corporations, down from 129 in 1976). In Germany, there is a significant distinction between the shares a commercial bank owns and the shares it votes. For example, the direct equity holdings of three commercial banks in Daimler-Benz were: Deutsche Bank (28.2 percent), Dresdner Bank (1.6 percent), and Commerz Bank (1.6 percent). The number of shares the banks voted at the annual meeting was: Deutsche Bank (41.8 percent), Dresdner Bank (28.2 percent), and Commerz Bank (12.24 percent). Mark J. Roe, *Some Differences in Corporate Governance*, 102 YALE L.J. 1927, 1938, 1988 (1993). There are three primary reasons for this disparity between equity positions and voting power. The first reason is the depositary voting right whereby German banks vote shares deposited in the bank by shareholders. Second, German corporations can and do limit the voting power of single shareholders, although this limitation does not apply to the aggregation of banks' direct equity holdings and shares voted through the depositary voting right. Third, German banks operate mutual funds and vote the shares held by the mutual funds. See Jonathan R. Macey and Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. (forthcoming 1995).

³² See Jonathan R. Macey, *Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 181-188 (1989).

III. RESTRICTIONS ON THE MARKET FOR CORPORATE CONTROL IN EUROPE

It is important to distinguish between three different conditions that affect the market for corporate control. These conditions are: (1) the ownership structure of the firm, especially the allocation of stock between insiders and outsiders; (2) internal rules of corporate governance; and (3) takeover law and regulation.

A. The Ownership Structure of the Firm

The more concentrated the ownership structure of a particular firm is, the less likely it will be that a hostile acquisition can take place. This is because a hostile acquisition, by definition, is a control mechanism resisted by incumbent management. When a single shareholder owns a controlling block of stock, and presumably supports incumbent management, the hostile acquisition becomes a negotiation with the owner of the controlling block, much like the purchase of a private company. In fact, it is not a *hostile* acquisition, because the takeover cannot succeed without the support of the single, controlling shareholder. Perhaps the only advantage to acquirors from public companies controlled by a single shareholder over private companies is access to information about the target firm. This, however, does not change the fact that where public firms have intensely concentrated ownership structures, there are no hostile takeovers *per se*, but merely negotiated acquisitions.

In Italy, France, Germany, Belgium, the Netherlands and Spain, hostile takeovers are *de facto* impossible because of the existence of intensely concentrated patterns of ownership. For example, in Italy, around five percent of the companies listed on the Milan Stock Exchange have more than fifty percent of their common stock in public hands.³³ Of this five percent, five companies are controlled by a holding company owned by a single family. For this reason, as Professor Ronald Gilson has observed, "only two companies in the entire Italian economy are

³³ 2 BARRIERS TO TAKEOVERS IN THE EUROPEAN COMMUNITY 12-14 (1989) [hereinafter 2 BARRIERS TO TAKEOVERS].

even theoretically subject to hostile take-over.³⁴ In France, over half of the 200 largest public and private French companies are family controlled. Similar conditions exist in Spain.³⁵ Sweden also has a significantly concentrated ownership structure.³⁶ An investigation by Coopers & Lybrand, conducted at the request of the U.K. Department of Industry and Trade, found significant regulatory obstacles to tender offers as an instrument of structural transformation in all member countries except the U.K., and, to a lesser extent, France. Coopers & Lybrand concluded that, outside of France and the U.K., hostile takeovers in Europe are extremely rare in practice.³⁷

In Germany and Italy, family control of even the largest corporations is also common and large corporate cross-holdings make hostile takeovers virtually impossible.³⁸ Moreover, in Germany, voting rights concentrated with banks further reduce the probability of hostile acquisitions of German firms.

These concentrations of share ownership make the legal rules concerning the market for corporate control less relevant. Nevertheless, for at least three reasons, these concentrations of control do not make the legal rules wholly irrelevant. First, these extreme ownership concentrations may be only a temporary phenomenon reflecting the re-emergence of European industry following the end of World War II:

The pervasiveness of concentrated family ownership, especially with respect to successful first-generation companies founded following World War II, reflect a member state's pattern of eco-

³⁴ Gilson, *supra* note 3, at 182. And, interestingly, one of those companies, Burgo, was rumored as the target of a hostile takeover bid. 2 BARRIERS TO TAKEOVERS, *supra* note 33, at 14.

³⁵ Gilson, *supra* note 3, at 182.

³⁶ In 1992, the largest shareholder coalition had an average equity fraction of 47.7 percent ranging from a minimum of 7.1 percent to a maximum of 96 percent and a vote fraction average of 54.6 percent ranging from 7.4 percent to 95 percent (dual-class shares are common in Sweden). Clas Bergström et al., *Strategic Blocking, Arbitrageurs and the Division of the Takeover Gain: Empirical Evidence from Sweden*, 3 J. MULTINAT'L FIN. MGMT. 217 (1993).

³⁷ 7 BARRIERS TO TAKEOVERS, *supra* note 25, at 47.

³⁸ Marcus Lutter & Brigitte Lammers, *Hostile Takeovers: Possibilities and Limitations According to German Law*, in DEFENSIVE MEASURES AGAINST HOSTILE TAKEOVERS 113 (J.M.M. Maeijer & K. Geens eds., 1990); John Cable, *Capital Market Information and Industrial Performance: The Role of West German Banks*, 95 ECON. J. 118 (1985); Franks & Mayer, *supra* note 26.

conomic growth and the life cycle of a particular company. These conditions will change in response to changes in the economic environment. As founders of significant numbers of post-war family companies reach retirement age [sic] concentration of ownership will dissipate.³⁹

Second, over time, it is likely that disputes, perhaps from weak performance, will emerge among the families and industrial groups that jointly control many European industrial corporations. Where this happens, shareholders are likely to feel disaffected and may encourage outside bidders. This is particularly likely to occur where one group or faction is employed within the firm while the other groups or factions are not. Conflicts are prone to arise because insiders are often less concerned about under-performance than they are about continuing consumption of the perquisites of corporate ownership and control, while outsiders are more concerned with the dividends and capital appreciation that follow superior performance.

Finally, it is possible that concentrated ownership can actually facilitate, rather than impede, the market for corporate control due to the simple fact that the transaction costs of effectuating a change in control will be less where an acquiror can assemble a control block by making a small number of strategic purchases from large block holders instead of making a public tender offer to all existing shareholders.

Thus, because of concentrated share ownership, a future European market for corporate control may not be characterized by the highly public tender offers that characterized the American takeover wave of the 1980s. Rather, negotiated block acquisitions will necessarily characterize the market for corporate control in Europe.⁴⁰

B. Firms' Internal Rules of Corporate Governance

Another large impediment to the emergence of a well-functioning market for corporate control is the set of internal

³⁹ Gilson, *supra* note 3, at 183.

⁴⁰ See Bergström et al., *supra* note 36 (reports 212 successful takeover bids out of 252 in Sweden between 1980 and 1992. Most bids were friendly and negotiated transfers of control. Less than 10% of the public tender offer bids were hostile).

governance rules by which many corporations often create nearly insurmountable obstacles to hostile acquisitions. For example, share voting restrictions in the form of dual class voting stock and ceilings on the number of shares that can be voted by a single shareholder present significant burdens on the European market for corporate control. Like the issues concerning the basic ownership structures of the firm, these burdens are not addressed by European Union directives concerning takeovers. However, unlike the possibly inefficient ownership structures described earlier, the inefficiencies contained in these internal rules of corporate governance may not be self-correcting.

Having multiple classes of stock with disparate voting rights (dual class voting stock) is common in several European countries, most notably Sweden.⁴¹ A company with dual class voting stock issues low-vote-power or non-voting stock to the public while management or a dominant shareholder group retains effective control of the company through the retention of a class of stock with superior voting rights.⁴² Even though a majority of the capital in a firm with dual class voting stock may have been raised from outside investors, the disparate voting rights can make outside takeovers of such firms impossible.

Capped voting arrangements can similarly retard takeovers. Under such arrangements, common in Germany,⁴³ the voting power of individual shareholders is capped at a certain level, regardless of how many shares are owned.

Both of these arrangements deprive outside investors of the ability to transfer control to others who value the control

⁴¹ In the U.K., there is no statutory prohibition against voting right differentiation, but the stock exchange prevents listed companies from introducing dual class shares. Portugal and Switzerland impose no regulation, while the Nordic countries, with the exception of Norway, limit dual class voting rights. Dual class shares are prohibited in several countries, e.g., Belgium, Germany and Italy. See EUROPEAN CORPORATE FINANCE LAW: A GUIDE TO M&A AND CORPORATE RESTRUCTURING LEGISLATION (1990) [hereinafter EUROPEAN CORPORATE FINANCE LAW]. This publication contains many details on the legislative environment in Europe relating to mergers, acquisitions and restructurings.

⁴² Kenneth Lehn et al., *Consolidating Corporate Control: Dual-Class Recapitalizations Versus Leveraged Buyouts*, 27 J. FIN. ECON. 557 (1990).

⁴³ See Franks & Mayer, *supra* note 26.

more.⁴⁴ However, the Proposed Fifth Directive concerning the structure of limited liability companies was amended to prohibit capped voting as well as dual class voting.⁴⁵ Thus, in the unlikely event that the Proposed Thirteenth Directive, which is applicable to most firm acquisitions, were amended to conform to the Proposed Fifth Directive, both dual class voting arrangements and capped voting would be impermissible.⁴⁶

Both of these types of defensive arrangements prevent the emergence of an effective market for corporate control. Professor Gilson has attempted to distinguish these two defensive devices by arguing that dual class voting arrangements are more benign than capped voting. He argues that dual class voting is a more desirable corporate governance device because control is retained by an owner/decision maker, while capped voting schemes operate to assure that no owner also controls.⁴⁷ This basis for a distinction is unpersuasive in the context of the market for corporate control. Both of these arrangements operate generally to concentrate ownership in the hands of incumbent management, and to prevent hostile takeovers. However, a more relevant distinction is that under a capped voting scheme it may be impossible to effectuate even a *voluntary* transfer of control. Thus, the ability of firms to limit the maximum number of shares a single shareholder can vote represents a significant potential burden on the European market for corporate control.

C. Takeover Regulation at the European Level

In addition to the concentrated ownership structure of firms in Europe and the restrictive European rules of corporate governance, the legislative framework regulating takeovers in Europe hobbles the development of a well-functioning market for corporate control in Europe. Of pivotal importance is the Proposed

⁴⁴ Interestingly, a pair of proposed rules would have prohibited dual class voting arrangements while authorizing capped voting. Article 52(3) of the Proposed Statute for a European Community, E.C. Bull. supp. May, 1989.

⁴⁵ Proposed Fifth Directive, *supra* note 8.

⁴⁶ The latest draft of the Proposed Thirteenth Directive is from 1990. See Proposed Thirteenth Directive, *supra* note 4. Due largely to its politically controversial nature, it is still in draft form.

⁴⁷ Gilson, *supra* note 3, at 186.

Thirteenth Directive which "constitutes the principal effort at harmonizing European takeover law."⁴⁸ In particular, a market for corporate control is considered to be an important instrument to monitor and raise the efficiency of resource allocation in a changing economic environment. The improving allocative efficiency by enabling larger efficient scales of enterprise is the primary objective of the Proposed Thirteenth Directive.⁴⁹

To meet this objective, the Proposed Thirteenth Directive appears to facilitate development of an efficiency-promoting market for corporate control by prohibiting management from taking defensive action after a hostile bid has been made. As Professor Gilson has presciently observed:

[T]he British governance model places the power to transfer control of a corporation with its shareholders much more effectively than currently is the case in the United States. Under General Principle 7 of the City Code on Take-overs and Mergers, target companies are essentially prohibited from taking defensive action once a bid is made. As a result, target management's decision not to participate in a friendly acquisition can be appealed to the shareholders by means of a hostile bid. The British model is clearly reflected in Article 8 of the Thirteenth Directive, which, in the words of the explanatory memorandum accompanying the directive, "require[s] the board of the offer company to refrain from adopting defensive measures without the authorizing of the general meeting of shareholders."⁵⁰

A conclusion that defensive measures should be prohibited is too simplistic. The matter is complicated because defensive measures also increase a target company's ability to negotiate a higher premium. The appropriate level of defensive measures is thus a matter of effecting a balance between the probability of receiving an offer, which decreases with the extent of defense, and the expected bid premium, which increases with the extent of defense. Stronger defensive measures promote the interests of the owners if the positive effect of a higher bid premium dominates the negative effect of the reduced possibility that

⁴⁸ *Id.*

⁴⁹ *Id.* at 177.

⁵⁰ *Id.*

someone will make a bid.⁵¹

However, because there is no reason to believe that the capital markets would be incapable of assessing the advantages and disadvantages of various defensive measures, there should be no reason to limit the power of companies to adopt takeover defenses. A prohibition against easily assessed defensive measures, such as poison pills, crown jewel lock-ups or high severance bonuses for target company management, may instead lead the target to adopt more costly and hard-to-assess measures that cannot easily be priced. One example is a defensive acquisition that increases the size of the potential target and thus makes it more difficult to acquire. Consequently, measures adopted to eliminate some impediments to takeovers may actually encourage the use of worse impediments.

In addition to the goal of allocative efficiency, the Proposed Thirteenth Directive has a second objective: to protect small minority shareholders in takeovers. To achieve this, the Proposed Thirteenth Directive contains three general principles: (1) equal bid requirements; (2) mandatory bid requirements; and (3) equal access to information.⁵²

The equal bid principle forces a potential acquiror to extend the same tender offer price to all share owners; price discrimination between large controlling block owners and small stockholders is prohibited.⁵³ The mandatory bid rule gives any shareholder the right to sell if a new controlling position is established where none existed before or a pre-existing controlling stake is transferred. This principle is implemented by requiring any share owner who has attained at least one-third of

⁵¹ See Andrei Shleifer & Robert W. Vishny, *Greenmail, White Knights, and Shareholder Interest*, 17 RAND J. ECON. 293 (1986).

⁵² The inspiration behind and the archetype for this legislative activity is the voluntary code of conduct, the City Code on Takeovers and Mergers, administered by a non-statutory body (the Panel). See City Code, *supra* note 50. With a few important exceptions, the Proposed Thirteenth Directive almost emulates the rules in the City Code.

⁵³ See Proposed Thirteenth Directive, art. 62(2), *supra* note 4. This principle is supplemented with special rules governing certain situations. For example, if there are different classes of shares (dual class structure), the typical European legal system permits tender offers that price discriminate between the classes. In the United States, similar principles were the basis for legislation directed at cash tender offers. See Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988)).

the target's voting rights to extend an offer to all shareholders for the remaining shares of the company.⁵⁴

The third principle concerns equal access to information. The Directive stipulates that target shareholders have a right to detailed information from the acquiror in connection with a tender offer.⁵⁵ Moreover, in order to enable the shareholders to evaluate the bid, it must be open for a specified minimum time period.⁵⁶ The European Community has adopted an additional Directive which requires publication of certain information when a major block of stock in a listed company is acquired or sold.⁵⁷

Although the Proposed Thirteenth Directive is intended to have fundamental, comprehensive and far-reaching effects, there is a conspicuous lack of a law and economics analysis of these effects. This Article attempts to rectify this by discussing the economic consequences of the three principles, as well as the conflicts between allocative and distributive objectives.

1. The Equal Bid Principle

The equal bid principle has, like the other parts designed to meet the distributive objectives of the Proposed Thirteenth Directive, the goal of equality and fairness of treatment — a goal that springs from the general socio-political canon of equal treatment. The equal bid principle assumes that positive take-over gain is not realized unless the bidder owns all of the target's equity.⁵⁸ Therefore, the mandatory bid rule is moot be-

⁵⁴ Proposed Thirteenth Directive, art. 4(1), *supra* note 4.

⁵⁵ *Id.*, preface at 8, art. 10.

⁵⁶ Article 12(1) specifies that the period for bid acceptance may be no less than four weeks and no more than ten weeks from the date the offering document is made public. *Id.*

⁵⁷ Council Directive 88/627, 1988 O.J. (L 348) 62.

⁵⁸ There are at least three general reasons why ownership of all target shares is more beneficial than just operational control: (1) if full ownership is established, operations can be restructured without objection from minority shareholders; (2) with a controlling interest of less than 100 percent of the shares, taxes must be paid separately on both firms' profits whereas with full ownership, profits and losses can be transferred between the firms in order to minimize the total sum of tax payments; and (3) finally, if the acquiror intends to invest heavily in the firm, but does not expect the minority shareholders to invest a proportionate amount, he may prefer full ownership.

cause the rational bidder seeks to own 100 percent of the target.

The equal bid principle is a prohibition on price discrimination between holders of large and small controlling blocks. It is designed to prevent takeovers in which a control premium is paid to controlling shareholders while small shareholders receive less due to their lesser bargaining power. However, some important threshold issues remain unanswered. Do legal rules that enact an equal division of gains from corporate control transactions maximize investor wealth? Does the equal bid principle truly raise firm value and minority shareholder wealth? Is the equal bid principle an appropriate policy instrument in the face of the dynamic transformations of corporate structures in Europe?

A proper analysis of the economic consequences of the equal bid principle must distinguish the *ex ante* and *ex post* effects of the rule, and assess the effects on various categories of shareholders. The temporal distinction is essential because the value of pre-existing firms contains an *ex ante* component that reflects the expected value of future takeovers: the discounted value of a takeover adjusted for the likelihood of its occurrence. An economic analysis of proposed rules is essential because it looks at how the value of a firm is affected by different legal rules while legislative initiatives often are motivated by and strictly consider *ex post* effects such as the distribution of an acquisition gain. Comprehensive economic analysis must integrate the effect of a rule change on the likelihood of the takeover with the distributive effects of a successful takeover.

It is necessary to differentiate between the effects on large, pivotal block holders and small shareholders because the rule presumes this ownership differentiation. In particular, the principle prohibits the sale of control blocks at a premium over the shares acquired from smaller stockholders.⁵⁹ It is essential to remember that an European takeover scenario probably includes large pivotal shareholders who have the capacity to negotiate better terms than the small shareholders. The blocking power of the large shareholders requires that a bidder must reach an agreement with these pivotal players.

The potential for strategic blocking by large shareholders in

⁵⁹ Proposed Thirteenth Directive, art. 62(2), *supra* note 4.

takeover attempts manifests itself under various target ownership structures and circumstances. The simplest case is that of a stockholder who controls a majority of the target's equity. But, even if a party controls less than fifty percent of the equity, a bidder may be forced to negotiate with this powerful minority because the alternative takeover strategy, acquiring the shares from many small stockholders, may impose prohibitively high transaction costs.

Furthermore, when the fraction of shares needed to accomplish a takeover is large, the likelihood of successfully blocking the takeover increases. When a buyer opts to bid for 100 percent of a target's shares, the compulsory acquisition limit rule opens a window for larger shareholders to block the bid and simultaneously eliminates this opportunity for smaller stockholders.⁶⁰ If a threshold percentage of the equity is tendered, generally ninety percent, the bidder has the option to compel the sale of the remaining shares at the same price at which the first shares were acquired. The motivation behind this rule is to facilitate takeovers by preventing small groups of stockholders from determining the success of a takeover. The structure of the rule gives blocking power to those who own enough stock to prevent triggering the compulsory acquisition limit rule. For instance, holders of ten-plus percent of stock in Swedish or U.K. corporations are necessary participants to ensure a bid's success. This forces a bidder to reach an agreement with the block holder concerning the acquisition share price.⁶¹

Although the equal bid requirement may at first seem innocuous and even fair, it is demonstrably unfair to minority shareholders except under a limited set of conditions.⁶² Ideally, the

⁶⁰ The Proposed Thirteenth Directive does not include a Compulsory Acquisition Rule (CAR). Other EU countries have implemented a CAR. Because the Proposed Thirteenth Directive does not address this issue, each country in the EU is free to adopt its own CAR variant. Most have not. See 1 BARRIERS TO TAKEOVERS, *supra* note 9, at 29.

⁶¹ Interestingly, because of the concentrated ownership structure that characterizes publicly listed corporations in continental Europe and Scandinavia, the Compulsory Acquisition Limit may force an acquiror to face *more* than one large incumbent shareholder with blocking capability.

⁶² For a formal analysis of the equal bid principle, see Clas Bergström & Peter Högfeldt, *The Equal Treatment Principle: An Analysis of The Thirteenth Council Takeover Directive of the European Community*, Stockholm School of Economics (1994).

equal bid principle shifts part of the acquisition gains from the purchasing company and large block shareholders to the target's small shareholders. However, if the number of successful acquisitions is reduced by the requirement, net gains for small shareholders may be reduced. The equal bid requirement will decrease the likelihood of acquisitions because discriminatory bids priced to favor controlling shareholders can make acquisitions less costly and thus more common.

In sum, policymakers must recognize the two countervailing effects of the equal bid principle. The guarantee that small shareholders will receive the same price offered to any shareholder, including insiders, will raise the average price offered to small shareholders. Simultaneously, smaller net gains result from the reduction in the number of offers. Determining which effect is dominant is an empirical question beyond the scope of this paper. Nevertheless, in light of the significant controlling blocks held by insiders in Europe and the likelihood of significant private benefits to owners of such blocks, it is reasonable to conclude that the equal bid principle will harm small shareholders by significantly lowering the probability of negotiated acquisitions. The ominous conclusion is that the effect of the equal bid principle is directly opposed to the objective of protecting the economic interests of target company shareholders. Equally troublesome is the reduction in takeover offers following the implementation of the equal bid principle — a result contrary to the goal of improved resource allocation through facilitation of corporate acquisitions. In fact, the disincentives faced by a potential bidder are so large that enactment of the equal bid principle demonstrably lowers the expected allocative and synergy gains accruing from takeovers.⁶³ The equal bid principle not only creates a conflict between stated allocative and distributive goals, but also works consistently against the allocative objectives.⁶⁴

⁶³ *Id.*

⁶⁴ In fact, one might ask whether the very starting point, namely special protection of the small shareholders of target firms is correct. Equity holders, in general, want to maximize the value of their portfolio which consists of shares both in the prospective target companies and in acquiror companies, and not just the value of a particular stock. Equal bid rules transfer wealth from acquirors to targets; a portfolio holding stocks of both firms shows no net gain from the implementation of equal bid rules and the portfolio owner is, therefore,

2. The Mandatory Bid Rule

A similar critical analysis applies with respect to the second instrument designed to achieve the distributive goal of the Proposed Thirteenth Directive: the mandatory bid rule. Any bidder trying to acquire control of a target corporation, where the intended acquisition added to existing direct or indirect holdings exceeds a certain percentage of the voting rights — Article 4(1) stipulates one-third of the voting rights — must extend an offer to purchase all the target's shares. Thus, an acquiror cannot acquire a controlling stake without making a bid for the remaining shares.⁶⁵ France, Italy and Norway have recently enacted similar mandatory bid rules with only slight variations in the percentage of equity necessary to trip the mandatory bid requirement.⁶⁶

The general motivation behind the mandatory bid rule is to protect investors from two-tier bids. According to Farrar et al., the mandatory bid rule in the City Code is derived from the notion that it seems wrong to compel shareholders to become minority shareholders in a company without giving them the option to sell their shares and that it is wrong to compel minority shareholders under an original controlling shareholder to become a minority to a new controlling shareholder. Therefore, universal bids are deemed necessary to protect investors.⁶⁷

indifferent to their presence or absence. Even an undiversified shareholder, interested solely in rules which transfer the profits to the target company if an offer materializes, is indifferent because he does not know whether his company will be an acquiring or a target company.

Furthermore, since takeover bids often come at significant premia over the pre-existing share prices of target firms, and because arbitrageurs and other investors often purchase in anticipation of such a bid being announced, it is likely, as the probability of a takeover goes up, that the value of all shares in the company will increase. Hence, the very foundation of the equal bid principle — the presumption of significantly different gains between large and small shareholders from takeovers — may be less convincing than at first blush.

⁶⁵ One difference between the City Code and the Proposed Thirteenth Directive is that the trigger limit for actual control is thirty percent of the equity in the former but one-third in the latter. 7 BARRIERS TO TAKEOVERS, *supra* note 25, at app. D1.

⁶⁶ EUROPEAN CORPORATE FINANCE LAW, *supra* note 41, at 139-40, 245, 294.

⁶⁷ This was one important reason why the French legislation was changed in May 1992. During the takeover by Pinault of Le Printemps, investors protested, and in some cases even sued in court, in order to have bids for all of

This suggests that the mandatory bid rule gives a costless option to target shareholders exercisable when there is a change of control. A rule that gives all shareholders such an option initially seems like a fair and innocuous measure that protects minority interests. However, that is not necessarily the effective result of the mandatory bid rule.⁶⁸

The optimal acquisition is to acquire only the minimum number of shares in the target firm necessary to obtain control.⁶⁹ This is because the price required to induce marginal shareholders to tender in a partial bid is lower than that needed to induce all shareholders.⁷⁰ The costs of a partial bid are lower in comparison to a full bid for additional reasons. By making an offer for only the smallest percentage of shares necessary to obtain control, outside bidders can reduce the likelihood of

their shares. Interestingly enough, Belgian law considers a mandatory bid rule to be a veiled protective device due to the fact that the 100 percent bid requirement increases the bidder's financial burdens as he has to offer to buy all shares to acquire control. Wymeersch, *supra* note 11, at 239.

⁶⁸ For an extensive formal analysis of the mandatory bid rule, see Bergström & Högfeldt, *supra* note 62.

⁶⁹ It should be noted that according to the City Code partial offers are possible under some circumstances. The Code requires an offer which would result in the acquiring company holding thirty percent or more of the voting rights to be approved by shareholders holding over fifty percent of the voting rights not held by the acquiror and persons acting in concert with it. This requirement may on occasion be waived if over fifty percent of the voting rights in the target company are held by a single shareholder. WEINBERG, *supra* note 11, at ¶ 2-023. Even though this option might seem difficult to use, it should be noted that this is a perceivable softening of the Panel's traditional approach, and, perhaps, the suspicion of partial offers will be even less in the future. WEINBERG, *supra* note 11, at ¶ 2-022.

⁷⁰ There are several reasons for such an upward sloping supply curve. Rene Stulz argues that such a curve may reflect that shareholders have different marginal tax rates. Rene M. Stulz, *Managerial Control of Voting Rights: Financial Policies and the Market for Corporate Control*, 20 J. FIN. ECON. 25 (1988). Simon claims that even with identical marginal tax rates, the supply curve can be upward sloping since shareholders have acquired their shares at different prices. Moreover, shareholders are rarely unanimous concerning the ability of the bidder. Certain outside shareholders are likely to disbelieve the ability of the outside acquiror to increase the value of the target firm, and thus will be willing to tender. Others hold more optimistic beliefs and therefore try to free ride.

holdout problems.⁷¹ Hence, the mandatory bid rule may substantially increase the acquiring costs for potential bidders and thereby discourage takeover attempts.⁷²

Moreover, the increased costs in the form of higher interest expense and greater exposure to risk can make it unprofitable for a bidder who has already identified improvements in efficiency to acquire control, to replace management and to change the physical plants and procedures. A mandatory bid rule can also prevent acquisition of a substantial position in a firm in order to learn more about the firm and its development potential before deciding to actually seek control.

In summary, the enactment of a mandatory bid rule may result in fewer productivity-increasing acquisitions. It is no coincidence that managers at several U.S. corporations have proposed the introduction of the mandatory bid rule into their companies' articles of incorporation — the rule is seen as a defense against hostile takeovers.⁷³ A general enactment of the rule within the EU would reduce the number of efficiency in-

⁷¹ For a discussion of the holdout problem, see Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free Rider Problem and the Theory of the Corporation*, 11 *BELL J. ECON.* 42 (1980).

⁷² This assertion is true in a general sense, but its magnitude may vary depending on particular circumstances. In the case of firms controlled by large block shareholders, the mandatory bid rule will almost certainly reduce the number of takeovers because it will effectively eliminate the private, negotiated transfer of control by requiring that the terms of any agreement reached with controlling owners be extended to all shareholders. In the case of widely-held firms, of which there are remarkably few in continental Europe, the mandatory bid rule will have, at worst, an ambiguous effect on the aggregate number of takeovers. In fact, the mandatory bid rule may even make takeover bids of widely-held firms more frequent, because the fixed costs of a takeover bid (researching the target firm, various regulatory filings, and publicity) will decline on a per-share basis as the number of shares in the bid increases, allowing for a higher per-share bid price (assuming, of course, no difficulty in amassing the capital necessary to make the 100 percent bid).

⁷³ The second wave of takeover statutes in the United States includes redemption rights that give shareholders cash redemption right against any buyer of at least 30 percent of the firms stock. Only three states adopted the redemption rights provision. See Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 *J. FIN. ECON.* 291, 299 (1989). For an interesting empirical analysis, see John Pound, *On the Motives for Choosing a Corporate Governance Structure: A Study of Corporate Reaction to the Pennsylvania Takeover Law*, 8 *J.L. ECON. & ORGANIZATION* 656 (1992).

creasing takeovers and reduce the welfare of shareholders. That is, the rule would be inconsistent with the two objectives of the Proposed Thirteenth Directive.

3. The Principle of Equal Access to Information

In addition to the two general principles of equal and mandatory bids, the EC Directives contain a third set of rules governing disclosure of substantial share acquisition,⁷⁴ requiring detailed offer documentation⁷⁵ and mandating a minimum bid acceptance period.⁷⁶ Like the mandatory bid rule and the equal bid principle, these obligations are designed to ensure that target company shareholders are protected from abuse by parties with information advantages.

a. Rules Governing Disclosure of Substantial Acquisitions of Shares

When a party buys a large block of shares in a company, its objective may be to create more favorable conditions for a subsequent tender offer. According to the EC Directive on Disclosure Requirements, existing shareholders in the target company, as well as others who trade in its shares, should have an opportunity to protect their interests.⁷⁷ The Directive stipulates publication of certain information when a major holding in a listed company is acquired or otherwise transferred. If a person (legal or natural) acquires or disposes shares of a listed company and if, following that transaction, the proportion of voting rights exceeds or falls below a certain threshold, the person must notify the company and the relevant authorities.

These rules make the identification of takeover candidates, perhaps those which could benefit from improvements in efficiency, more costly. This is because the disclosure requirements increase the costs to a potential bidder purchasing a significant fraction of the stock in order to more closely evaluate the potential target. In addition, the disclosure rules exacerbate the

⁷⁴ Council Directive 88/627, 1988 O.J. (L 348) 62.

⁷⁵ Proposed Thirteenth Directive, art. 10, *supra* note 4.

⁷⁶ *Id.*, art. 12.

⁷⁷ Council Directive 88/627, 1988 O.J. (L 348) 62.

problem identified by Grossman and Hart, namely that shareholders will only sell if the offeror pays at least what the shareholders believe the shares will be worth after a takeover and consequent firm restructuring.⁷⁸ If an acquiror bids at a lower price than the perceived post-acquisition value, minority shareholders will not sell *ex ante* so they can take advantage of the *ex post* share price increase caused by the new firm management. Thus, to purchase from rational shareholders, an acquiror must pay a premium nearly equal to the amount of the expected improvement in the value of the firm. This leaves the acquiror with no profit. Because the improvements in efficiency which follow acquisition are public goods (no shareholder can be excluded), bidders have an incentive to understate the magnitude of intended improvements. In order to make future "understatements" credible, successful bidders also have an incentive to limit the scope of actual reform as well.

Mandatory disclosure rules make the benefits of acquisition perceived by both acquirors and target shareholders congruent. Empirical evidence from the United States indicates that target shareholders can quantify potential gains simply by possessing information about the identity of the potential acquiror.⁷⁹ One way of overcoming the collective action problem identified by Grossman and Hart is to permit acquirors to accumulate large blocks of stock in target companies in secret — that is, acquisition without disclosure to target shareholders. The European rules move in the opposite direction by mandating disclosure; this reduces aggregate shareholder welfare because the probability of a bid is reduced.

b. Obligation to Provide Information before a Tender Offer and Minimum Tender Period

The Proposed Thirteenth Directive requires that bidders provide target shareholders with detailed information about the offer.⁸⁰ Moreover, in order to provide target shareholders sufficient time to evaluate a bid, the Proposed Thirteenth Directive

⁷⁸ Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986).

⁷⁹ Jonathan R. Macey & Jeffrey M. Netter, *Regulation 13D and the Regulatory Process*, 65 WASH. U. L.Q. 131 (1987).

⁸⁰ Proposed Thirteenth Directive, art. 10, *supra* note 4.

mandates a minimum bid acceptance period.⁸¹ The idea underlying these disclosure obligations is to safeguard target shareholders from "low-ball" offers made by bidders with information advantages.

Requiring the provision of detailed offer documentation and a period of acceptance generates drawbacks similar to those governing the disclosure of substantial acquisitions. The requirements give the target company's shareholders information and time to arrive at a decision but simultaneously give potential rivals free information about the target company, as well as time to investigate and act on this information. Because the costs of discovering under-valued targets and launching a bid for control are high, these disclosure rules provide a significant disincentive to acquire information because of the likelihood of free-riding by competitors.⁸²

The disclosure requirements impair the private economic value of the information, and thereby the incentives to produce it. Stringent information requirements therefore imply that fewer players in the market will search for inefficiently run companies, seek more efficient production plans or identify potential synergistic gains. This is analogous to patent law where patent protection is a necessary condition for high investment in research and development.

Empirical analysis of U.S. data shows that bid premia rose and bidder returns declined significantly after the disclosure rules of the Williams Act were introduced in the United States.⁸³ Competition for the target company quite simply pushed premia up.

This analysis of the rules requiring equal and mandatory

⁸¹ This period is a minimum of four weeks beginning with the public announcement of the bid. *Id.*, art. 12.

⁸² A simple example illustrates this point. Suppose that an initial bidder has investigated \$1,000,000 in search costs to discover that a target company with 1,000,000 shares outstanding is undervalued by \$50 per share. The initial bidder could bid no more than \$49 per share for the target, because such a bid, when combined with the \$1,000,000 in search costs, would eliminate all positive returns to the bidder. But a second bidder, free riding on the first bidder's sunk costs in search, could bid up to the full \$50 per share. Knowing this, of course, the initial bidder would decline to incur the sunk search costs in the first place.

⁸³ See, e.g., Michael Bradley et al., *Synergistic Gains from Corporate Acquisitions, and their Division Between the Stockholders of Target and Acquiring Firms*, 21 J. FIN. ECON. 3, 31 (1988).

bids and equal access to information show that, because the rules are likely to reduce the number of takeovers (and consequent synergy gains), the distributive and allocative goals of the Proposed Thirteenth Directive are not met and are actually hampered.

IV. THE POLICY MAKER'S DILEMMA AND THE NEED FOR PRIVATE ORDERING

Up to this point our analysis has emphasized the benefits of a well-functioning market for corporate control. In particular, the need to restructure the rigid ownership and organization structures of the post-World War II period in light of the rapidly evolving global economy suggests a large role for the market for corporate control in Europe. The post-war productive environment is characterized as one in which "a small number of long-lived standardized products employing a production process designed to maximize scale economies is giving way to one in which the market demands a vastly larger array of specialized products, that have dramatically shorter product cycles and whose manufacture demands a different kind of production process and industrial organization."⁸⁴ The flexible production requirements of the 1990s require new corporate and capital configurations.

The mandatory bid rule, the equal bid principle and the rules requiring equal access to information are conspicuous because they increase the power of entrenched blocks to thwart attempts at hostile acquisitions. These rules threaten to make it more difficult for Europe to break away from the concentrated, interlocking corporate ownership structures that deprive its manufacturing firms of the flexibility they need to adapt to new market conditions.⁸⁵ Although these rules may be relatively well suited for corporate control markets characterized by widely dispersed, atomistic shareholders unable to fend for them-

⁸⁴ Gilson, *supra* note 3, at 175.

⁸⁵ For a discussion of the relatively inflexible corporate governance scheme in Germany, see Friedrich Kübler, *Institutional Investors and Corporate Governance: A German Perspective*, in INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 565 (Theodor Baums et al. eds., 1994). This work also contains several examinations of structural impediments to efficient corporate control in Europe.

selves in the face of a hostile takeover threat, they are unsuited for a market characterized by highly concentrated share ownership.

Note that this article does not argue that defensive tactics in general are never desirable. In fact, such tactics can be highly useful and welfare enhancing. For example, outside investors may only be able to persuade managers to make costly, firm-specific human capital investments necessary to achieve operational improvements if they can erect defensive barriers sufficient to ensure that the value of these human capital investments will not be appropriated by outside bidders. Similarly, it may be the case that as share ownership becomes more widely dispersed, the dangers of strategic behavior by bidders will come to outweigh the dangers of strategic behavior by target management or large block holders. Where this is the case, it may be in the interest of particular firms to operate in a regulatory environment characterized by some or all of the defensive protections discussed here.

The primary point is that the defensive devices being mandated for European companies could be adopted *privately* by individual firms, as part of their corporate charters or articles of incorporation. It is peculiar and perverse to mandate these rules for all firms when they are appropriate for only a small subset of European corporations. This is particularly true in light of the fact that, to the extent management controls the corporate proxy machinery and has interests divorced from shareholders, their natural proclivities will be to opt for levels of takeover protection that are too high, rather than too low, from the perspective of outside equity holders. The proposed rules restrict the adoption of defensive measures when rules dissuading the adoption of such measures are actually needed.

Put differently, it is clear that the policymakers' dilemma applies with full force to the rules discussed here.⁸⁶ No single comprehensive regulation like the mandatory bid rule or the equal bid principle will be optimal for all firms. Consequently, the interests of shareholders are better served if regulators do not interfere in the choice of bidding strategy, but rather allow shareholders to choose for themselves the defensive strategy

⁸⁶ See Jonathan R. Macey, *Takeover Defense Tactics and Legal Scholarship: Market Forces Versus the Policymaker's Dilemma*, 96 YALE L.J. 342 (1986).

that is best for them. In its quest for unified rules, the European Community has ignored this classic dilemma of regulation.

Thus, just as requiring mandatory or equal bids is unhelpful, so too is the elimination of dual class voting stock or capped voting. Even though these voting structures are sub-optimal for many firms, they are optimal for other firms.

V. CONCLUSION

The overall aim of the Proposed Thirteenth Directive is to create more effective corporate structures in Europe and to protect the interests of small shareholders. Our analysis illustrates the potential conflict between these two allocative and distributional objectives. Under the Proposed Thirteenth Directive, European takeover regulation will produce too few takeovers. These regulations impose significant structural barriers to the efficient redeployment of corporate assets. To the extent that any regulation in this area is justified, such regulation should stimulate acquisitions, because firms have private incentives to erect takeover barriers.

Our overall conclusion is that implementation of the equal bid principle and the mandatory bid rule as well as the set of rules governing equal access to information impedes changes in European industrial structure. Thus, the Proposed Thirteenth Directive is contrary to the declared purpose of transforming European corporate structures. Furthermore, in effect, the Proposed Thirteenth Directive is diametrically opposed to the explicit goal of protecting shareholder interests — particularly those of smaller shareholders. Accordingly, the objectives and the measures to achieve them are not properly aligned. As a policy package the proposed Thirteenth Directive is inconsistent. Regulatory reform, even if enacted with the best of intentions, is not an inherent guarantee of better outcomes.